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Alert

ABI Commission's Plan Process and Confirmation Recommendations: A Mixed Bag for Secured Creditors

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This *Alert* is one of a series published by Schulte Roth & Zabel that analyzes the report released on Dec. 8, 2014 ("Report") by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 ("Commission"), which recommended numerous changes to Chapter 11 of the Bankruptcy Code ("Bankruptcy Code"). This *Alert* focuses on the Commission's proposed changes regarding the Chapter 11 reorganization plan process, plan confirmation requirements and their impact on secured creditors. The set of proposals represents a mixed bag for secured creditors. Some of the proposals — particularly those endorsing uniform standards for third-party releases and adoption of a market-based approach for determining a "cram-down" discount rate — should be viewed favorably by secured creditors. On the other hand, the voting-related proposals may reduce creditor leverage and, in turn, increase the risk of impairment of creditor recoveries. To compensate for this additional risk, secured creditors may demand higher fees or interest when providing financing to borrowers.

Uniform Standards for Third-Party Releases and Exculpatory Provisions Will Promote Creditor Participation in the Plan Process and Reduce Forum Shopping

Reorganization plans commonly include exculpation and release provisions that offer various levels of immunity to a debtor and third parties.[1] According to some commentators, these protections encourage "parties to engage in the [Chapter 11] process and assist the debtor in achieving a confirmable plan — actions that [case constituencies] and their professionals, and certain parties (such as key lenders) may not be willing to undertake in the face of litigation risk." Report, at 251. Of course the cost of extending immunity to nondebtors is borne by the creditors who are foreclosed from pursuing potential sources of recoveries. For most Chapter 11 cases, however, the Bankruptcy Code does not specifically address the permissibility of including third-party exculpation and release provisions in a plan.[2] This void has caused some courts — most notably the U.S. Courts of Appeals for the Ninth and Tenth Circuits[3] — to reject plans offering third-party releases under any circumstances, finding that such provisions run afoul of

[1] The Report describes a release as "a relinquishment of claims and causes of action that the debtor or third parties may have against certain nondebtor parties." Report, at 250. Releases can cover a broad spectrum of claims unrelated to a debtor's Chapter 11 case. Exculpation clauses, on the other hand, are typically narrower than releases, covering claims related to "conduct during the chapter 11 case" such as negotiation, and pursuit of confirmation, of a plan. *Id*.

[2] The Bankruptcy Code authorizes releases for third parties in connection with the establishment of a court-approved trust fund for the benefit of asbestos personal injury claimants. *See* 11 U.S.C. § 524(g).

[3] *See, e.g.*, *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *Landsing Diversified Properties-II v. The First National Bank and Trust Company of Tulsa (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592 (9th Cir. 1991).

Bankruptcy Code Section 524(e).[4] Other courts have embraced a more flexible approach but have adopted varying standards for approval of nondebtor releases.[5]

The Commission concluded that both third-party exculpation and release provisions "might be permissible in appropriate cases if certain factors were satisfied, [but] determined that different standards of review were warranted." Report, at 251. With respect to exculpation, the Commission endorses Bankruptcy Code amendments providing immunity to estate representatives (such as the debtor, a statutory committee and their professionals) and other third parties for "claims relating to matters that should be resolved once the plan is confirmed and becomes effective." Report, at 251-52. The Commission, however, declined to recommend a set of objective factors that could be used to determine if a party's contributions warranted exculpation. Report, at 252. In terms of scope, the Commission concluded that exculpatory clauses should protect parties if their conduct constituted simple negligence, but that exculpation for conduct constituting "gross negligence and other standards of conduct" should be determined on a case-by-case basis in light of the "facts of the case and public policy considerations." *Id*. Moreover, immunity should not extend to "bad actors." *Id*.

The Commission recommends a more rigorous standard for approving nonconsensual third-party releases given the adverse impact such releases could have on creditor recoveries.[6] As discussed above, some courts already employ balancing tests to evaluate nonconsensual releases. The Commission reviewed these tests and ultimately endorsed the test developed in the *Master Mortgage* decision.[7] The *Master Mortgage* test considers:

- The identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate;
- Whether the nondebtor has contributed substantial assets to the reorganization;
- Whether the injunction is essential to reorganization;
- Whether a substantial majority of the creditors agree to such injunction — specifically, whether the affected class or classes have "overwhelmingly" voted to accept the proposed plan treatment; and
- Whether the plan provided a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

[4] Bankruptcy Code Section 524(e) provides in relevant part: "[D]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e).

[5] For example, both the Sixth and Seventh Circuits have approved plans providing third-party releases, but the Seventh Circuit would allow a bankruptcy court "to release third parties from liability … if the release is appropriate and not inconsistent with any provision of the bankruptcy code," while the Sixth Circuit requires seven factors to be present, including findings that the nondebtor contributed substantial assets to the reorganization and that the plan provides a mechanism to pay for all or substantially all of the classes affected by the injunction. *See In re Ingersoll Inc.*, 562 F.3d 856 (7th Cir. 2009); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002).

[6] According to the Report, consensual third-party releases (i.e., releases binding only on creditors who take some affirmative act consenting to the release) should be approved so long as the salient terms of the release have been adequately disclosed. *See* Report, at 252.

[7] *In re Master Mortg. Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).

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Among the *Master Mortgage* factors, the Commission concluded that particular weight should be given to "contributions of nondebtor parties, percentage recoveries by the affected creditors, and mechanisms established to facilitate recoveries to those creditors." Report, at 256.

The exculpation and release standards endorsed by the Commission should be viewed by creditors as positive developments. In jurisdictions that currently prohibit any form of nondebtor releases, these changes should encourage creditors to take a more active role in the reorganization process and, in turn, facilitate confirmation of consensual plans. Further, the adoption of uniform standards should discourage forum shopping and reduce the attendant prejudice to creditors.[8]

Market-Based Factors Must Be Considered to Determine "Cram-Down" Discount Rate

The Bankruptcy Code permits confirmation of a plan that has been rejected by a class of creditors so long as the plan satisfies a set of additional requirements commonly referred to as "cram-down" provisions as to the rejecting class. For a rejecting class of secured creditors, the "cram-down" provisions require a plan proponent to demonstrate that the present value of deferred cash payments to the secured class under the plan will equal the allowed amount of that class's claims.[9] This requirement ensures that secured creditors will receive plan distributions equal to the current value of their claims, even if those distributions are paid over time. As with any present value calculation, the key ingredient in determining whether a plan complies with this "cram-down" requirement is the discount rate — the lower the rate, the lower the future payments would need to be in order to equal the current value of the claims. Naturally, secured creditors would prefer a higher rate.

Because the Bankruptcy Code does not address what discount rate — a so-called "cram-down rate" — should be applied, the question has been left to the courts. The U.S. Supreme Court encountered this issue in the Chapter 13 context in *Till v. SCS Credit Corp.*[10] There, the Court held that the discount rate should be determined using a formula approach. Under the formula adopted in *Till*, the risk-free rate of interest is increased by an amount intended to reflect "the risk of default in the given case, the nature and quality of the collateral, and the duration and feasibility of the [reorganization] plan." Report, at 235. Since the 2004 *Till* decision, several courts have applied the formula approach in the Chapter 11 "cram-down" context.[11] Although cited for its simplicity, the formula approach may force secured lenders to take post-reorganization notes at below-market rates.

The Commission rejects the use of the *Till* approach in the Chapter 11 context and instead recommends adoption of a general market approach to determine the appropriate discount rate. According to the Commission, the *Till* approach would not be appropriate because the discount rate it generates "is not based on the economic realities of the particular case and, consequently, likely undercompensates creditors for the risk present in the postconfirmation credit." Report, at 237. On the other hand, a market approach would consider factors relevant to Chapter 11 cases, such as "the cost of capital for

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[8] In their motion seeking to establish venue in Delaware, a group of second lien lenders of Caesars Entertainment Operating Company Inc. argued that the bankruptcy court should not defer to the debtor's preferred choice of venue "given that the purpose of [the debtor's] restructuring and its apparent desire to seek venue [in another jurisdiction] is to obtain releases and injunctions and other benefits for non-debtor insiders." *In re Caesars Entertainment Operating Company, Inc.*, Bankr. D. Del. Case No. 15-10047 (KG) [D.E. No. 26].

[9] *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II). Although not applicable to this discussion, Bankruptcy Code Section 1129(b)(2)(A) offers two other means for a plan to satisfy the "cram-down" requirements as to secured creditors. *See* 11 U.S.C. §§ 1129(b)(2)(A)(ii) and (iii).

[10] 541 U.S. 465 (2004).

[11] *See, e.g., In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

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similar debt issued to companies comparable to the debtor as a reorganized entity." Report, at 237. In the event a market rate is not available or "an efficient market does not exist, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor." Report, at 237.

Both borrowers and secured creditors would benefit from adoption of a market-based approach to determining the appropriate "cram-down" rate. Knowing that below-market notes cannot be foisted on them, secured creditors will retain significant leverage in negotiation of plan terms and exit strategies.[12] Moreover, there will be less of a need for secured lenders to compensate for this risk by charging higher fees to borrowers or imposing other costs at the time the parties enter into a loan agreement.[13]

Commission Recommends Broad Prohibition of Class-Skipping Gift Plans

When facing a challenge from a junior class of creditors or even equity holders, a senior class can settle the dispute by providing a tip to the "squeaky wheel" class from their own distributions under a plan. Suppose, however, that there is an intermediate class between the senior and junior creditors that has rejected its treatment under the plan. Although courts generally favor settlements, there is a question in that scenario as to whether the proposed "gift" violates the "absolute priority" rule, which proscribes plan distributions to junior classes unless and until senior creditor claims — here, the intermediate class — have been satisfied in full.[14]

The Commission recognizes that courts and commentators have developed differing views on the permissibility of gifting arrangements. Report, at 238. Those in favor of allowing these "class-skipping" transfers assert that the estate is not harmed when "senior creditors … [use] their own money to pay the junior creditors." Report, at 238. The Commission itself acknowledged that class-skipping transfers promote important bankruptcy objectives such as "resolv[ing] objections to plan confirmation, facilitat[ing] the debtor's reorganization, and dispers[ing] value further down the debtor's capital structure." Report, at 239. Courts rejecting this arrangement, however, "raise concerns regarding self-enrichment and collusive activities that can benefit some stakeholders at the expense of others who do not have sufficient bargaining power to participate in the negotiations." Report, at 238. The Commission also expressed concern about "lowering barriers to confirmation of feasible plans … at the expense of creditor priorities, appropriate checks on self-interested behavior and undue influence." Report, at 239.

Upon careful review of these competing considerations, the Commission found that "the potential abuses of gifting outweighed any benefits in class-skipping, class-discriminating, and intra-class discriminating cases," and recommended a broad prohibition on direct and indirect class-skipping transfers. Report, at 239-40. Following the lead of several circuit courts, the Committee's recommendation on this score appears sensible.[15] Still, the Committee could have developed a principle that deters self-dealing and other abuses while preserving the parties' flexibility to propose a confirmable plan. Indeed, any concerns the Committee has about prejudice to the intermediate class resulting from *voluntary* transfers by the senior class to junior creditors should be alleviated by a

[12] *See* our Oct. 15, 2014 *Client Alert*, "Bankruptcy Court Approves Non-Market Cramdown Rate on Momentive Secured Creditors."

[13] *Id.*

[14] 11 U.S.C. § 1129(b)(2)(B)(ii).

[15] *See, e.g.*, *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011); *In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005).

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separate Committee proposal that would *mandate* transfers of plan value from the senior class to the intermediate class.[16] A broad prohibition on class-skipping transfers may render confirmation of a plan more difficult, time-consuming or costly, even in cases where the concerns underpinning the Committee's recommendations are not present.

Elimination of Confirmation Requirement Mandating Acceptance of at Least One Impaired Creditor Class Would Reduce Creditor Leverage, Increase Borrower Costs

The cram-down provisions provide the means to confirm a plan over a rejecting class of creditors, but a plan must still secure acceptance from at least one class of creditors who are true third parties of the debtor and whose claims would be impaired under the plan.[17] This baseline acceptance requirement "ensure[s] that a plan ha[s] some creditor support"[18] and may deter existing management from proposing a plan that appeals solely to the interests of prepetition equity holders or other insiders.

The Commission, however, questioned the continued utility of Bankruptcy Code Section 1129(a)(10) and whether the provision "allowed creditors to hold up the confirmation process" or encouraged debtors to "strategically group[] claims to achieve at least one accepting impaired class of creditors." Report, at 260. On balance, the Commission found that the "potential delay, cost, gamesmanship, and value destruction attendant to section 1129(a)(10) … significantly outweighed" any gating role served by Bankruptcy Code Section 1129(a)(10). Report, at 261. Accordingly, the Commission recommended eliminating Bankruptcy Code Section 1129(a)(10).

If enacted, this proposal would undermine a key source of leverage currently available to creditors. Although a debtor's efforts to rig the vote to secure confirmation will remain subject to the "good faith" requirement of Bankruptcy Code Section 1129(a),[19] elimination of Section 1129(a)(10) would make it easier for debtors to confirm a "cram-down" plan. Indeed, a "good faith" challenge is likely to be costly and the outcome unpredictable. Thus, although a borrower might enjoy additional leverage once it files a Chapter 11 petition, secured creditors will likely compensate for this risk by demanding higher interest or more fees under the loan agreement.

"One Creditor, One Vote" Rule May Increase Cost of Obtaining Blocking Position

Acceptance of a plan is determined on a class-by-class basis. Bankruptcy Code Section 1126(c) provides that a plan must be accepted by: (1) a majority of creditors within a class (the "numerosity" requirement); and (2) creditors holding at least two-thirds of the value of the claims within a class.[20] When confirmation hinges on acceptance from all or certain critical creditor classes, debtors may attempt to mitigate the uncertainty surrounding plan solicitation by grouping creditors strategically. Creditors can counteract these moves by acquiring enough claims in a given class to prevent a plan from meeting either of the Section 1126(c) requirements referenced above. In other words, a creditor can

[16] *See* our Feb. 5, 2015 *Client Alert*, "'Redemption Option Value': Mandatory Distributions to Out-of-the-Money Stakeholders."

[17] *See* 11 U.S.C. § 1129(a)(10). Generally speaking, a class of claims is considered impaired if a plan proposes any alteration to the claim holders' legal, equitable and contractual rights.

[18] Report, at 258.

[19] 11 U.S.C. § 1129(a)(3) ("The court shall confirm a plan only if … [t]he plan has been proposed in good faith and not by any means forbidden by law.").

[20] 11 U.S.C. § 1126(c).

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block acceptance of a plan if it holds: (1) over 50 percent of the number of claims in a class; or (2) over one-third of the aggregate value of claims within a class.

The Commission observed that the classification and voting tug-of-war between debtors and creditors has not only led to distraction and diversion of resources, but also has failed to protect minority creditors in accordance with the original purpose of the numerosity and dollar-amount requirements of Bankruptcy Code Section 1126(c). Report, at 259. At the same time, "changes in debtors' capital structures and the dynamics of Chapter 11 cases arguably decreased the relevance of [the classification and voting] objectives." *Id*.

With this in mind, the Commission proposed to replace the numerosity requirement with a "one creditor, one vote" rule. Under the proposal, the plan would satisfy the acceptance requirements if over one-half of the *creditors* — rather than one-half of the *claims* — in a class accept the plan. *Id*. In determining whether this requirement has been met, entities and their affiliates that are subject to "common investment management" would be entitled to a single vote in respect of all claims held by such affiliated group in a particular class. If enacted, this proposal may increase the cost of obtaining a blocking position. Under current law, creditors can block a class by acquiring a large number of small dollar-value claims. The Commission's recommendation, however, would force creditors to acquire at least one-third of the *value* of the claims within a class.

Conclusion

The Commission's proposed modifications to the plan-related Bankruptcy Code provisions represent a mixed bag for secured lenders. On the one hand, adoption of a market-based discount rate would likely be a boon to secured lenders' recoveries. Yet, blanket prohibitions on voluntary class-skipping transfers may frustrate attempts to resolve disputes with junior creditors and, ultimately, lead to delays in recoveries.

Secured lenders seeking to take an active role in the case may benefit from changes that clarify nondebtor parties' entitlement to releases and exculpation. On the flipside, debtors may have less incentive to negotiate with secured lenders whose leverage may be reduced through the elimination of the requirement that at least one impaired class accept the plan. In our view, borrowers will likely bear the expense of any increased risk to creditors through higher financing-related fees and costs.

Authored by Michael L. Cook and Aaron B. Wernick.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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